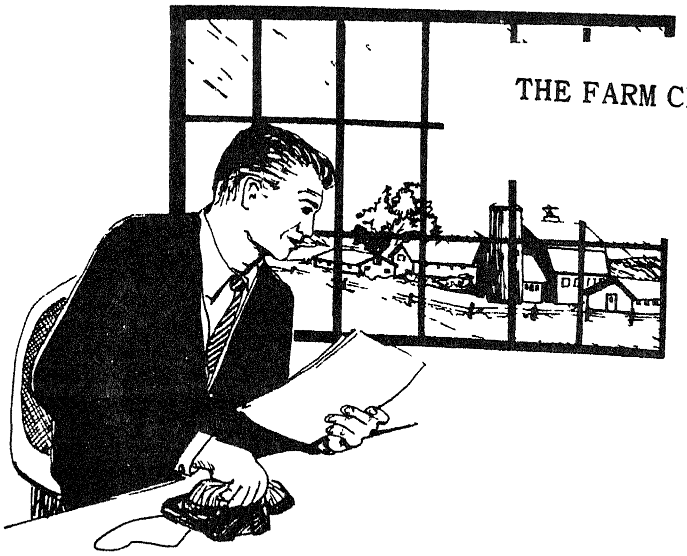


THE FARM CREDIT MAN'S ROLE IN FARM BUSINESS MANAGEMENT DECISIONS[1]

Credit has been recognized as a key tool in profitable farming and will be even more important in the next decade. Yet, improperly used, it may complicate problems or even result in a financial disaster for the farmer. P.C.A. was established to furnish credit on more realistic terms for the farm business than was available at that time. P.C.A. can be proud of the low loan loss record, but that is not the total loss picture. The farmer borrower realized his loss before the credit agency assumed any loss. The loss has been protected to some extent by the rapid appreciation of land values during the past twenty years. This appreciation of farm real property is likely to continue at a rate depending on how well inflation is controlled. The farmer borrower can develop a false sense of business success based on increases of inventory values caused by appreciation. Does the credit man have an obligation to help the farm operator develop an up-to-date operational business picture to show this current business progress. The alert credit man of today will answer this question with a "yes". Managerial abilities on the part of the farmer and the credit man will become increasingly more important to meet the competition ahead to stay in business. A major responsibility of the P.C.A. organization has been to put the farmer member

---

1/ Prepared for a Four State Credit Manager's and EFR Coordinator's Conference, Federal Intermediate Credit Bank, Louisville, Kentucky by John E. Moore, Extension Economist, Farm Management, Ohio State University, October 24, 1973.

first and to do what is best for him. This means knowing enough about his business to recognize good or poor management decisions.

The credit man is a most influential person on the farmer's management team. He contributes to farm management decisions whether he wants to or not. Helping a farmer survive in the short-run is important, but to gain enough knowledge about his business to help him plan and grow over time should be the ultimate objective of both the farmer and the credit man. It is important that the credit man appreciates the importance of continuous training for him as well as for the farm businessman in order to be competitive in the future.

DECISION-MAKING ENVIRONMENT

A. Constant or Unchanging Factors

The credit man and the present-day farmer needs to understand the economic and management principles that are useful in making farm business decisions. These principles do not change over time and once understood are of continued use.

There are a number of basic economic and management principles that can be usefully applied when making decisions about a farm business. An understanding of these principles and their application can be helpful to all persons working in the field of agriculture. The quantity and quality of resources available vary from farm to farm and as a result the crop and livestock enterprise combination that maximizes returns will be different on each farm. A few of the important principles are: a) Diminishing returns or applications of marginal concepts; b) Opportunity costs - the place capital will give highest return; c) Relationship of variable and fixed costs to management decisions; d) Substitution of resources; e) Enterprise combination - competitive, supplementary and complementary; f) Time discount; and g) Risk and uncertainty.

One of the most difficult problems facing the farm operator is obtaining adequate current knowledge and understanding about his farm business to know how the principles apply and their effects on his business. Part of the current knowledge needed is what is taking place in the farm business and the other part is outside factors affecting the business.

B. Changing Factors

1. Changing Resource Mix and Producer Output

While the amounts of land and labor in farming are remaining constant or declining, capital and management imputs are increasing rapidly.

Skilled managers have adapted to the capital oriented environment. However, many poor managers have substituted too much capital in form of big machinery and other automation for labor resulting in high fixed costs and low profits. Others have not substituted enough capital for labor, resulting in low labor productivity, and again low profits.

In the past, labor was the major resource cost, but the thrust of modern-day farming is the increased use of capital and management. This adjustment is resulting in larger farms with much higher capital investments for the major producers.

The farm producer mix approximates --

Total Production		Producers
50%	produced by	6%
80%	produced by	20%
20%	produced by	80%

A very high percent of the 80% producer category and sizeable percentage of the middle group of producers work 100 days or more off-farm. This is part of the changing environment that has influence on loan policies and hopefully on the standard of living for the farm family.

Profitable expansion opportunities will continue to exist for farmers skilled in using capital and labor resulting in lower costs per unit. Despite possible lower farm prices, their lower costs and larger volume will give them above-average earnings. The gap continues to widen between the profits of the above average producer and below-average farmer.

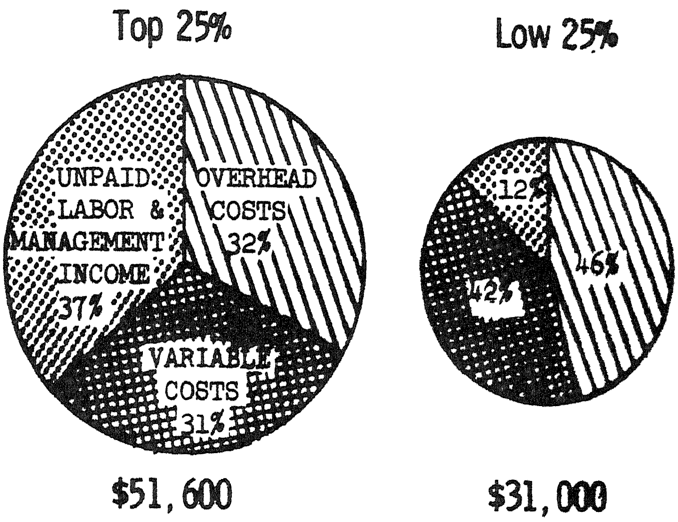
2. Wide Variation in Costs and Profit Between Similar Type Farmers

The variation in profits between the average of the top 25% and low 25% farm group gets wider as time goes on regardless of type of farming. Volume per farm is not the quick answer. Volume per man and per set of modern farm equipment may have more influence. As credit men, are we tuned in on some of the basic differences in cost structures of the high and low income farmers of similar size and type?

For example, the Annual Year End Farm Business crop summary for 1972 showed the Ohio owner operators of the top 25% income group averaged $9.01 per hour for unpaid labor and management. This was over twice the average hourly earning in the middle 50% farms of $4.28, and over four times the average of $1.45 per hour for the farms in the low 25%. In terms of income per full-time operator, the top 25% averaged over $28,600, while the low 25% averaged $5,200.

Note in Figure 1, on the following page, the difference in the amount of gross farm income absorbed by overhead and variable cost leaving a great difference in what is left for labor and management income.

Figure 1. Ohio General Crop Farms 1972 Average Gross Income of Top 25% and Low 25% and Percent Allocation of Gross Income

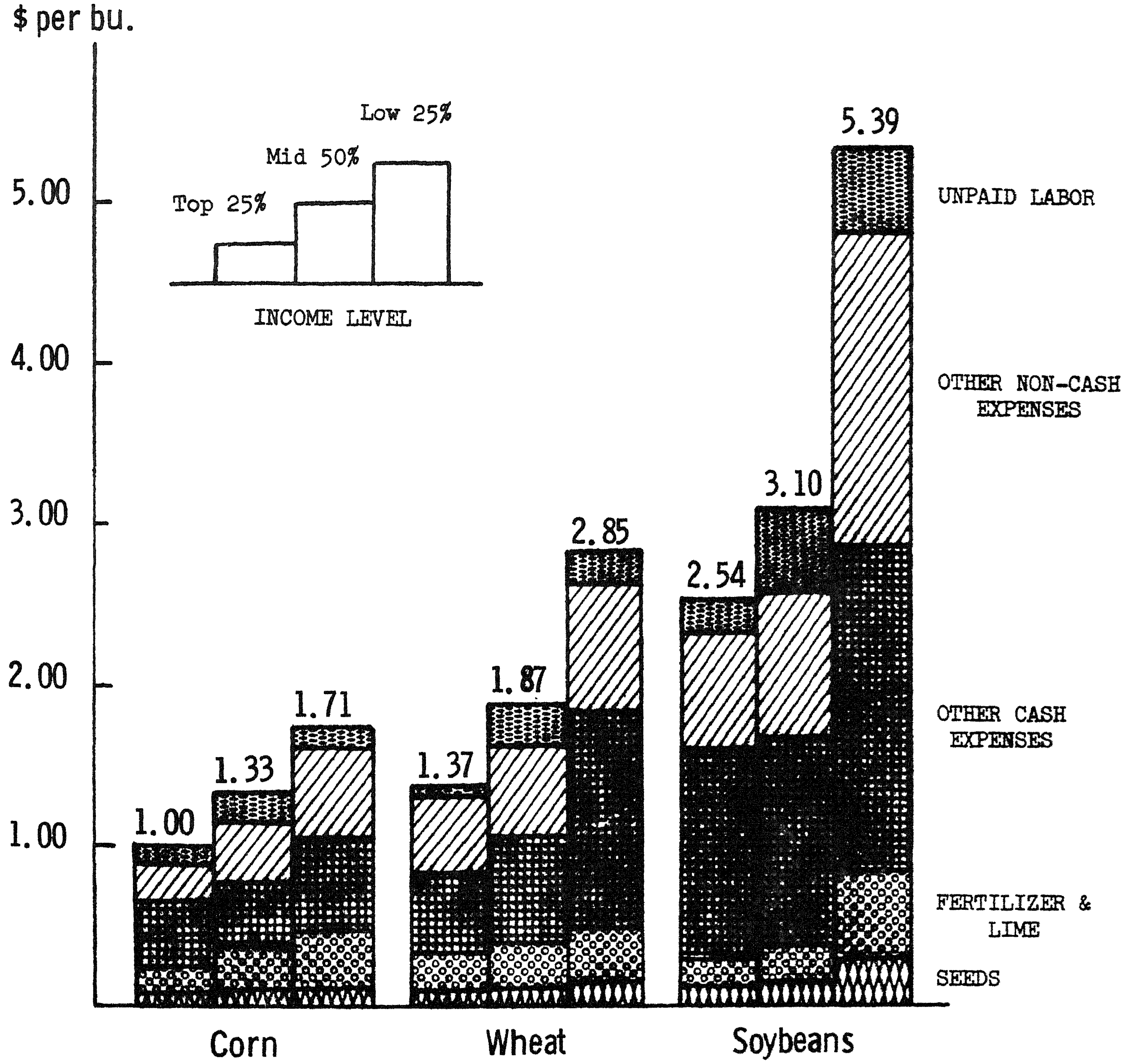


Costs per unit went down as profit per farm increased as noted in Figure 2, on the following page. Some farmers have said, we don't want to know this much about our business to have this type of detailed analysis. What is even more discouraging is to have a credit man promoting this type of philosophy. Most year-end record analyses will give a farmer this type of information and the credit man is in the key position to encourage the farmer to participate whether he cooperates with the college, P.C.A., or any other record analysis program.

FIGURE 2

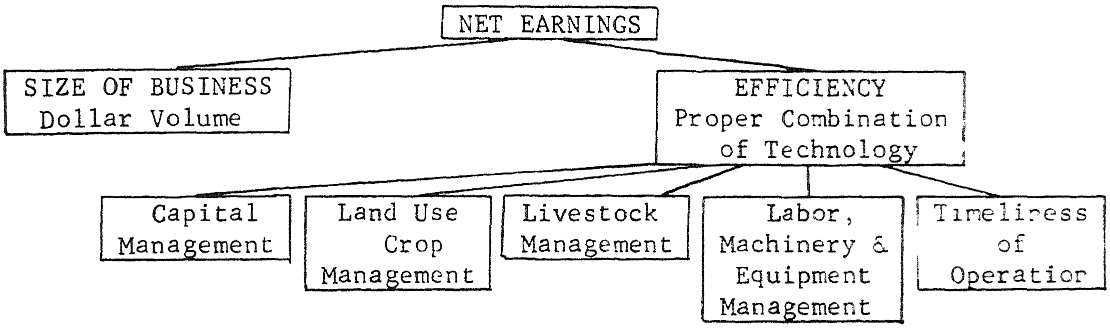
COST PER BUSHEL OF PRODUCING CORN, WHEAT, AND SOYBEANS

OHIO, 1972



Source: Farm Business Analysis Report 1972, Ohio General Crop Summary, ESO No. 141, Department of Agricultural Economics and Rural Sociology, Ohio State University, Columbus, Ohio

Efficiency and size are the two main factors affecting profit as is illustrated by the following diagram.



3. <u>Financial Position of the Farm Sector in 1973-74</u>

Higher farm prices are misleading to the non-farm public and to the poor farm managers. High grain, protein, and other input costs result in a record expenditure year for the livestock man in 1973 and a further increase of 7 to 9 percent is anticipated in farm production expenses in 1974. Net farm income in 1974 is predicted to be down 10% over 1973.

As the old saying goes, "Some people can't stand prosperity." This will be true for those who base long-time plans on short-time prices and over invest in machinery and buildings on borrowed money.

The market value of farm assets rose 9.2 percent during 1972 reaching a record level of $370.6 billion on January 1, 1973. The total volume of farm debt outstanding rose 7.6 percent to $72.0 billion. The estimated 10 percent increase in real estate values accounted for much of the growth in assets.

Farm land prices in Ohio may increase more percentage-wise from the fall of 1972 to fall of 1974 than in any other consecutive two-year period in the past 60 years. Ohio land prices increased 15.8 percent in March, 1972 to March, 1973 with a further increase expected this year. In only 3 years since 1933 have land values declined in Ohio. Declines were frequent from 1921 through 1933.

There are many implications for farmers and buyers. Observations would suggest: 1) time is growing short for investors seeking capital gains in the short and intermediate term, 2) land owners contemplating selling land in the next few years might consider selling in the near future, 3) budgeting and cash flow expectations should be conservative recognizing political decisions and world conditions are difficult to anticipate, 4) owner-operators need to analyze whether their profit prospects are better on owning additional land or on their present land base, and 5) investors and owner-operators need to recognize profits requires efficient production--average producers may find they paid too much for land.

4. Change in Resource Control Philosophy

Since the Thomas Jefferson days many farmers have held as their main objective to own all the land, livestock and machinery in their farming operation. This is still a worthy objective, but it is becoming more and more impossible to obtain. The philosophy is rapidly changing in today's agriculture to the main objective being the use of all possible resource control techniques to obtain enough land, machinery, etc. to effectively keep the available labor and management productively employed. This last objective more nearly maximizes the operator's labor and management income.

The pressures to over invest in machinery and buildings, particularly, has caused many credit men much worry and has meant failure for many farmers. This is sometimes called failing because of new paint disease and results in leaving monuments behind. Some of this could be avoided by encouraging the farmers to analyze more objectively other techniques to gaining control of resources in addition to ownership like:

1. Leasing or renting land, machinery and livestock. This is not always an option open in every community.
2. Multi-farming arrangement (partnerships-partial, limited, or full partnerships and farm incorporations).
3. Custom hire
4. Exchange work - machinery and labor
5. Co-ownership of assets
6. Other contract arrangements

5. <u>Changes in Income Tax and Estate Settlement Consequences</u>

Income tax management is part of good farm management and in too many cases the lack of timeliness of action causes higher tax liability for many farmers. In addition, changes in the tax laws during the past decade that benefited the farm business could have been more rapidly adapted for the best interest of the farmer.

Farm estate settlement costs have drastically increased during the past decade and the lack of planning results in unnecessary shrinkage of the family assets. Credit men have contributed to enlightenment in this area, but much more needs to be done.

CHARACTERISTICS OF FOUR MAIN TYPES OF FARMERS

1. <u>Low Resource Farmer</u> - may be inefficient in production and underemployed. Thus, his expansion options are limited because of present low income and he is in no position to expand capital indebtedness. Because of this weak financial position and perhaps poor management, he could become another creditor's nightmare.

The low resource farmer generally has these options: a) get better with present resources, b) get out of farming, or c) find outside income to supplement his farm earnings. Generally he needs to improve his efficiency and here is where credit can be effectively used plus perhaps increase his level of employment without incurring a great amount of debt in form of capital assets.

2. Skilled Laborer Farmer - In many instances his production and earnings are sufficient so he can maintain his present situation especially if his family demands aren't increasing

   Though some improvement in efficiency is always possible, a big increase in income may come only from investing more capital to improve the output of his labor and from being willing to manage hired labor.

   Effective guidance from a credit man can improve his income considerably. Encouraging participation in training activities and more time spent on the business analysis aspects can be rewarding.

3. Wheeler-Dealer or Creditor's Nightmare - He just knows enough to be dangerous about the use of capital. The less his credit agency knows about his finances the better he likes it. Generally continuing his present operation or getting bigger are poor options--he is the sell-out candidate unless a sudden price rise saves him for a few years. This type brings home the basic necessity for the credit advisor to know the man and his track record before striking up a relationship.

4. Skilled Farm Businessman - The successful capital-oriented farm manager generally has all options open to him. He can maintain his present satisfying position. He can get better or bigger or both. Or he can leave farming and employ his management skills and capital resources elsewhere. This type challenges the professionalism of the credit man and other farm educators in the community.

   This group of farmers will probably use over 80% of the total volume of credit and will require that lenders be prepared to give specific advice in the farm management area. The questions are who and how will the data be prepared in a meaningful manner for improved decision making and for analysis by the lender, and how do we provide the farm management advice when needed?

SUGGESTED ROLE OF THE CREDIT MAN IN FARM BUSINESS MANAGEMENT-DECISION MAKING - -

Considering the complexity of the modern farm decision-making environment requiring a knowledge of the constant and changing economic factors at work the most valuable credit will:

1. Continue to place emphasis on the man factor. Winning the farmer's confidence and developing a free two-way communication channel concerning his credit use.
2. Place high priority on continuous training program for credit men as well as encourage his borrowers to become more professional. Provide quality management advice in some form.
3. Continue to strive to fit the loan terms to the farmer's income stream.
4. Help farmers consider alternative methods of resource control in addition to ownership.
5. Encourage all and require some borrowers to develop a current information base (modern farm record program) whether it is done by an accountant, a college program or by P.C.A. This is primarily for the farmer's benefit to secure his credit based on an operational statement (cash flow) supplemented by a financial statement. This affords the best basis for improved farm decision making including wise use of credit. More accurate projections and budgets are possible resulting in a much improved job of forward planning. "No one plans to fail, but many fail because of lack of planning."

6. Alert farmers more in the future to the merits of income tax management.
7. Be concerned about the farm organization plan that will minimize the cost of inter-generation farm transfer. It is unbelievable, the shrinkage in farm assets that takes place in estate settlements on the larger farm units when effective estate planning is absent.
8. Be concerned about competition and P.C.A.'s image in the credit field. Important factors are: a) quality of service--a loan can be safe from P.C.A.'s standpoint but still be a bad loan from the farmer's standpoint; b) competitive cost of credit to the farmer.
9. Take a more active part in co-sponsoring educational programs for cooperators with the agricultural extension service in your county, district and state.

In summary, more attention will be given to repayment capacity or income producing ability of the farm business which is closely aligned with appraisal of the operator's management ability. Complete and accurate business records are a must for planning, problem identification, and determining repayment capacity.

Competitive credit agencies will take an increasingly active role in management counseling and training on behalf of their cooperators.